

The following is the Franchise Tax Board's analysis of Senate Bill 38 (Lockyer/Pringle), as amended August 28, 1996.

**Subject: Conformity/Miscellaneous Credits/Manufacturer's Investment
Credit/Medical Savings Accounts/Net Operating Loss**

Summary

Among other things this bill would do the following:

1. Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), amend the existing research credit by increasing the allowable percentages for qualified research expenses and basic research payments. Also, for taxpayers engaged in specified biopharmaceutical and biotech activities, include university hospitals and certain cancer centers in the definition of qualified organizations for the basic research credit. (Page 6 of this Bill Analysis)
2. Increase the amount of assets a small business may elect to treat as an expense in the year acquired from \$10,000 to \$12,500 for taxable year 1997 and to \$15,000 for taxable years starting on or after January 1, 1998. (Page 9)
3. Allow a flat 75% deduction for "qualifying dividends" received by a water's-edge group while retaining the current law deduction of 100% for dividends resulting from specified construction projects. This provision of the bill would repeal the current rules regarding base period amounts and foreign payroll factors that determine the amount of the allowable dividend deduction. Additionally, this provision would allow a proportionate offset of interest expense against the deductible dividends. (Page 10)
4. Conform to the newly enacted federal law to allow a deduction for medical expenses for the unreimbursed expenses for qualified long-term care services provided to the taxpayer, the taxpayer's spouse or the taxpayer's dependents (subject to the present-law floor of 7.5% of adjusted gross income). Long-term care insurance premiums would be treated as medical expenses based on a graduated scale ranging from \$200 to a maximum of \$2,500 of premiums, based on the individual's age before the close of the taxable year. (Page 11)

5. Conform to newly enacted federal law that, within limits, allows a deduction or gross income exclusion for contributions to an individual's medical savings account (MSA). This provision would apply only to those individuals allowed the deduction/exclusion under federal law and filing California returns. (Page 12)
6. Conform to the newly enacted federal changes allowing a \$2,000 deduction for contributions to spousal (nonworking spouses) Individual Retirement Accounts (IRAs). (Page 13)
7. Continue the exclusion from gross income for educational assistance provided by an employer to an employee in an amount not to exceed \$5,250. Effective July 1, 1996, the educational assistance excluded under the bill would not include any graduate level education of a kind normally taken in a program leading to a law, business, medical, or other advanced academic or professional degree. In addition, the exclusion would be operative without regard to federal law regarding the taxation of amounts received under an employer-provided educational assistance program. (Page 15)
8. Provide a reduced minimum franchise tax of \$600 for corporations with gross receipts, less returns and allowances, reportable to this state of less than \$1 million. The reduced tax would apply only to the first income year, commencing on the date the bank or corporation is incorporated. (Page 17)
9. Extend expired provisions of the Revenue and Taxation Code (R&TC), relating to employee stock ownership plans (ESOPs), that conform to the federal tax treatment of (1) rollover sales of stock to employee stock ownership plans or certain cooperatives, and (2) the dividends paid deduction. (Page 19)
10. Amend the Manufacturers' Investment Credit (MIC) to: (1) add semiconductor equipment manufacturing and certain aerospace manufacturing to the definition of "qualified taxpayer" for the special purpose building provision; (2) add taxpayers engaged in certain biopharmaceutical and biotech activities to the definition of "small business"; and (3) make technical changes. Also, amend the sales tax law to allow a taxpayer, who is both a manufacturer and lessor of tangible personal property which would qualify for the MIC, to pay sales tax on that property. (Page 20)

Under the net operating loss (NOL) rules, add taxpayers engaged in certain biopharmaceutical and biotech activities to the definition of "new business." (Page 22)

11. Increase the maximum amount of wages qualified for the enterprise zone hiring credit from 150% to 202% of the minimum wage when paid to up to 1,350 qualified employees employed in aircraft manufacturing activities located in the Long Beach Enterprise Zone. (Page 24)
12. Conform B&CTL to federal law by increasing the maximum limit for charitable contributions from 5% to 10% of a taxpayer's net income and allow those contributions in excess of the limit to be carried over for five years. (Page 25)

13. Create an enhanced oil recovery credit for independent oil producers equal to one-third of the credit allowed by federal law for projects located within California. (Page 26)
14. Under the PITL, exclude eligible small businesses, defined as businesses with less than \$1 million in annual gross receipts, from the alternative minimum tax (AMT). (Page 28)
15. Conform the PITL to three and B&CTL to two changes made to federal law in 1993, as follows:
 - (A) The treatment of income from the discharge of qualified real property business indebtedness. (Page 29)
 - (B) The provisions that repealed the stock-for-debt exception in determining income from discharge of indebtedness. (Page 30)
 - (C) The provisions that added to the list of tax attributes that are reduced in a discharge of indebtedness situation. (Page 31)
16. Under the PITL and the B&CTL, establish a 50% tax credit for the construction or rehabilitation of farmworker housing to meet the requirements of the Employee Housing Act. Under the B&CTL, this bill additionally would establish a 50% tax credit for commercial lenders for foregone interest income on loans used to finance qualified expenditures for qualified farmworker housing. (Page 32)
17. Under the PITL and the B&CTL, create a tax credit equal to \$15 for each ton of rice straw grown in California and purchased by the taxpayer. (Page 36)
18. Under the PITL and the B&CTL, allow a 50% tax credit to eligible small businesses for expenses up to \$250 for complying with the federal Americans with Disabilities Act (ADA) of 1990. The credit provisions would be based on a comparable federal credit with a few exceptions. (Page 37)
19. Allow an organization to qualify for state tax exempt status if it is formed by three or more otherwise exempt organizations to pool their resources in an arrangement to provide self-insurance coverage. (Page 39)
20. Allow taxpayers a tax credit equal to 50% of the transportation costs donated for transporting any donated agricultural product to a nonprofit organization. (Page 42)
21. Conform to federal provisions enacted in 1993 that exclude from the definition of moving expenses certain costs including those relating to: (1) the sale of the old residence, and the purchase of the new residence in the general location of the new job, (2) meals consumed while traveling and while living in temporary quarters near the new job, (3) pre-move house hunting trips, and (4) temporary living expenses for up to 30 days in the general location of the new

job. This provision also would conform to federal provisions that (1) increase the mileage limit from 35 miles to 50 miles, (2) allow as a deduction in calculating adjusted gross income moving expenses not paid or reimbursed by the taxpayer's employer, and (3) exclude from gross income moving expenses paid or reimbursed by the taxpayer's employer. (Page 43)

22. Conform state law to the newly enacted federal denial of a deduction for interest paid or accrued on any indebtedness from one or more company-owned life insurance policies covering any individual who is an officer or employee of, or financially interested in, any trade or business carried on by the taxpayer. The current law deduction is retained for up to 20 key persons. Interest paid or accrued after December 31, 1995, on debt from a life insurance contract covering a key person is capped by reference to Moody's Corporate Bond Yield Average-Monthly Average Corporates. (Page 45)
23. Phase-in conformity to the federal provision that requires corporations to pay 100% of the tax for the current year in four installments to avoid a penalty. In addition, this provision would conform to the annualization method changes. (Page 46)
24. Conform to the federal law requiring securities dealers to value their inventories, and certain non-inventory assets, using the mark-to-market accounting method. (Page 47)
25. Conform to federal provisions to expand the definition of "disqualified interest" for purposes of disallowing a portion of the interest deduction by a thinly capitalized corporation. (Page 49)
26. Conform to federal provisions that require that payments made to retiring or deceased partners for unrealized receivables and goodwill be treated as made in exchange for property and not as a deduction for the partnership. (Page 50)
27. Allow the Employment Development Department (EDD) to disclose certain new-employee information to Franchise Tax Board (FTB) for tax enforcement purposes. (Page 51)
28. Conform to the federal denial of a deduction for travel expenses paid or incurred for a spouse, dependent, or other individual accompanying a person on business travel. (Page 51)
29. Conform the PITL to the federal law that requires the depreciation deduction, for nonresidential real property, to be determined by using a recovery period of 39 years in lieu of 31.5 years used under current law. (Page 52)
30. Expand California's Nexus (Voluntary Disclosure) Program to include S corporation shareholders. (Page 53)

SUMMARY OF TAX REVENUE ESTIMATE

This bill would result in a net revenue losses for fiscal years 1996-97, 1997-98 and 1998-99 as follows:

Provision of Bill	Fiscal Years (\$ in millions)		
	1996-97	1997-98	1998-99
1. Research And Development Credit	-\$6	-\$22	-\$27
2. Small Business Expensing	-\$2	-\$11	-\$15
3. Unitary Law	-\$7	-\$10	-\$12
4. Long-Term Care Deduction	-\$2	-\$9	-\$10
5. Medical Savings Accounts	-\$4	-\$8	-\$10
6. Spousal IRAs/Conformity	-\$3	-\$8	-\$9
7. Education Assistance Exclusion	+\$7	+\$3	-\$7
8. Minimum Franchise Tax	-\$6	-\$8	-\$5
9. ESOPs Conformity	-\$6	-\$4	-\$4
10. MIC/Aerospace Clean-Rooms/NOL/Manufacturer Lessors	\$0	-\$2	-\$6
11. Aerospace/Enterprise Zone Hiring Credit	-\$2.7	-\$2.7	-\$2.7
12. Corporate Charitable Contributions Deduction	-\$3	-\$2	-\$2
13. Enhanced Oil Recovery Credit	-\$2	-\$2	-\$2
14. Alternative Minimum Tax (AMT)	-\$2	-\$2	-\$2
15. Discharge Of Indebtedness	-\$3	+\$2	+\$4
16. Farmworker Housing Credit	-\$0.5	-\$0.5	-\$0.5
17. Rice Straw Credit	\$0	-\$0.4	-\$0.4
18. 50% Credit For Disabled Compliance	-\$0.3	-\$0.3	-\$0.3
19. Non-Profit Insurance Risk Pools	-\$0.3	-\$0.2	-\$0.2
20. Credit For Costs Of Transporting Charitable Donations Of Agriculture Products	-\$0.2	-\$0.2	-\$0.2
21. Moving Expenses	+\$25	+\$25	+\$25
22. Company-Owned Life Insurance Policies	+\$10	+\$15	+\$20
23. Corporation Estimated Tax	\$0	+\$11	+\$13
24. Mark-To-Market	\$0	+\$10	+\$10
25. Restriction Of Deduction Of Interest To Foreign Entities	+\$3	+\$3	+\$4
26. Payment To Retired Or Deceased Partners	+\$2	+\$2	+\$3
27. Disclosure of EDD's New Employee Registry Information	\$0	+\$1	+\$1
28. Spousal Travel	+\$1	+\$1	+\$1
29. Depreciation Of Real Property	\$0	+\$1	+\$1
30. Expansion Of Nexus Program	\$0	+\$2.5	+\$2.5
TOTAL	-\$2	-\$15.8	-\$30.8

IMPLEMENTATION CONSIDERATION

Except as discussed under Item 11, Aerospace/Enterprise Zone Hiring Credit, implementation of the provisions of this bill would occur during the department's normal annual system update.

POSITION

Neutral.

The staff's position is determined by administrative considerations and does not take into account tax policy considerations or revenue impact on the state. However, these issues are discussed in the analysis.

1. **RESEARCH AND DEVELOPMENT CREDIT**

EFFECTIVE DATE

The provision increasing the research credit rates would apply to taxable or income years beginning on or after January 1, 1997. The provision modifying qualified research for certain biopharmaceutical and biotechnology activities would apply to income years beginning on or after January 1, 1996.

SPECIFIC FINDINGS

Federal law allows taxpayers a research credit for amounts paid or incurred before June 30, 1995, which is combined with several other credits to form the general business credit. The research credit is designed to encourage companies to increase their research and development activities.

Under **federal law**, the research credit has two separate components: (1) the differences between qualified research expenses and a base amount and (2) the difference between basic research payments and a base period amount. The allowable credit amount is the sum of 20% of the difference between the taxpayer's qualified research expenses for the taxable or income year and the base amount, and 20% of the difference between the taxpayer's basic research payments and the base period amount.

"Qualified research expenses" must be eligible for expensing or amortization, be conducted in the United States, and be paid by the taxpayer. The research expenses must meet an additional three-part test to guarantee that the research is truly experimental in nature.

For qualified research expenses, the "base amount" is the greater of:

- 50% of the current year qualified research expenses; or
- a fixed base amount, calculated as follows: the taxpayer's qualified research expenses first must be computed as a percentage of its gross receipts, using a base period between 1984 and 1988. This amount is called the fixed-base percentage and cannot exceed 16%. The fixed base amount is this percentage multiplied by the taxpayer's average annual gross receipts for the four years preceding the current tax year.

For "start-up companies" which were not in existence during the mid-1980s and which may not have the proper factors to determine the base amount, the fixed-base percentage is established in the law and varies every year.

"Basic research payments" must be paid by a corporate taxpayer to a qualified organization with respect to research involving any original scientific investigation which does not have a specific commercial objective. "Basic research" does not include research conducted outside the United States, or research in the social sciences, arts, or humanities. A qualifying organization includes most colleges, universities, and tax-exempt scientific research organizations.

For purposes of the basic research credit, the "base period amount" is a minimum basic research amount plus a maintenance-of-effort amount.

The minimum basic research amount is the greater of (1) the amount of credit-eligible basic research payments during the base period, or (2) 1% of the average of in-house research expenses, contract research expenses, and credit-eligible basic research payments during the base period. The base period used in making this calculation is the three-tax-year period ending with the tax year that immediately precedes the first tax year beginning after 1983.

The maintenance-of-effort amount is the average of all nondesignated university contributions made during the base period, adjusted by a cost-of-living factor, less nondesignated university contributions made during the current tax year. For this calculation, a "nondesignated university contribution" is defined as any charitable contribution to a qualified organization which (1) was not used to calculate the credit during any year in the base period or (2) does not meet the definition of basic research payment.

For "start-up" companies, the minimum basic research amount may not be less than 50% of the basic research payments for the year that the credit is being claimed.

The federal credit was based on amounts paid or incurred before June 30, 1995, but was extended by the Small Business Jobs Act of 1996 to apply from July 1, 1996, through May 31, 1997.

California conforms with specific modifications to the federal research credit, namely:

- the state credit is not combined with other business credits;
- research must be conducted in California to qualify for the California credit;
- the credit percentage is reduced to 8% for qualified research and 12% for basic research;
- the definition of "gross receipts" differs;
- research which has a specific commercial objective may qualify as basic research; and
- amounts paid or incurred after June 30, 1995, can qualify for the credit.

In order to duplicate federal law which allows the credit for basic research payments only to corporate taxpayers, the B&CTL allows the credit based on qualified research expenses and basic research payments, while personal income taxpayers are allowed the credit only for qualified research expenses.

The California research credit is allowed indefinitely for taxable and income years beginning on or after January 1, 1987.

This provision would amend the existing research credit to increase the allowable credit percentage from 8% to 11% for qualified research expenses. Thus, the qualified research expenses portion of the credit would be calculated as 11% of the difference between the taxpayer's qualified research expenses for the taxable or income year and the base amount (as defined in federal law).

This provision would increase the credit percentage for basic research payments from 12% to 24% for corporate taxpayers. The basic research portion of the credit would be calculated as 24% of the difference between the taxpayer's basic research payments and the base period amount (as defined in federal law).

Also, for corporate taxpayers engaged in specified biopharmaceutical research and biotech research and development, **this provision** would include hospitals run by public universities and certain cancer centers in the definition of "qualified organization" for purposes of the basic research credit. The taxpayer's biopharmaceutical activities would have to (1) satisfy at least one definition in Standard Industrial Classification Codes 2833 (Medicinal Chemicals and Botanical Products), 2834 (Pharmaceutical Preparations), 2835 (In Vitro and In Vivo Diagnostic Substances), 2836 (Biological Products), 3826 (Laboratory Analytical Instruments), 3829 (Measuring and Controlling Devices), 3841 (Surgical and Medical Instruments and Apparatus), 3842 (Orthopedic, Prosthetic, and Surgical Appliances and Supplies), 3843 (Dental Equipment and Supplies), 3844 (X-Ray Apparatus), or 3845 (Electromedical and Electrotherapeutic Apparatus) and (2) be using organisms or materials derived from organisms, and their cellular, subcellular, or molecular components to provide pharmaceutical products for human or animal therapeutics and diagnostics. For biotechnology research and development, taxpayers would have to be involved in research and development activities regarding the application of recombinant DNA technology or pharmaceutical delivery systems.

This provision would define a qualified cancer center as one which is both tax-exempt under federal law and owned by a tax-exempt organization, has been designated a "specialized laboratory cancer center," and has received Clinical Cancer Research Center status from the National Cancer Institute.

This provision would allow corporate taxpayers involved in the designated biopharmaceutical and biotechnology research and development activities who make payments to the specified university hospitals and cancer centers to claim the basic research credit on these payments.

This provision also would make minor technical changes to the research credit.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue loss from this provision is estimated to be \$6 million for fiscal year 1996-97, \$22 million for fiscal year 1997-98 and \$27 million for fiscal year 1998-99.

2. SMALL BUSINESS EXPENSING

EFFECTIVE DATE

Applies to assets placed in service after January 1, 1997, for taxable years beginning on or after January 1, 1997, and similarly for 1998.

SPECIFIC FINDINGS

Prior to the 1993 Revenue Reconciliation Act, both federal law and California law for noncorporate taxpayers provided that in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment could elect to deduct up to \$10,000 of the cost of qualifying property placed in service for the taxable year.

In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The \$10,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

While the above \$10,000 limit remains current California law for noncorporate taxpayers, the 1993 Revenue Reconciliation Act increased that limitation for federal purposes to \$17,500. This federal limit was further increased by the Small Business Job Protection Act of 1996 from \$17,500 phasing up to a maximum of \$25,000 in the year 2003 and thereafter. The 1996 limit of \$17,500 increases to \$18,000 in 1997; \$18,500 in 1998; \$19,000 in 1999; \$20,000 in 2000; \$24,000 in 2001; \$24,000 in 2002; and \$25,000 in 2003 and thereafter.

This provision would increase the amount of assets a small business may elect to treat as an expense in the year placed in service from the 1996 limit of \$10,000 to a maximum of \$12,500 for taxable year 1997 and \$15,000 for taxable years 1998 and thereafter.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision would result in revenue losses of \$2 million in fiscal year 1996-97, \$11 million in fiscal year 1997-98, and \$15 million in fiscal year 1998-99.

3. UNITARY LAW

EFFECTIVE DATE

The 75% deduction would apply to taxable or income years beginning on or after January 1, 1996. However, the proportionate interest offset would apply to taxable or income years beginning on or after January 1, 1997.

SPECIFIC FINDINGS

California law allows corporations to elect to compute their income derived from or attributable to California sources without considering the income and activities of various unitary foreign incorporated affiliates. This method is known as a water's-edge election.

Under the **water's-edge election**, banks and corporations conducting a worldwide unitary business are allowed to elect to compute their California income by reference, in general, only to those corporations which are organized within the United States or conduct business within the United States.

Under **California law**, a water's-edge group may exclude a portion of the dividends which it receives from entities which conduct less than 20% of their activities in the United States and which are more than 50% owned by a member of the water's-edge group. Generally, the deductible portion is 75%. This percentage varies based upon several factors, including the amount of dividends received in a set of base period years from similar entities and the change in the relative levels of "foreign payroll" to "United States payroll" between the base years and the current year. Dividends which result from construction projects where the location is not subject to the taxpayer's control are allowed a 100% deduction.

In addition, California law provides that the water's-edge group must assign the interest expense which relates to the excluded dividends to those dividends, and the interest expense will not be allowed as a deduction against the other income of the unitary business.

This provision would amend the existing law relating to the qualifying dividends of water's-edge groups by allowing a flat 75% deduction for all "qualifying dividends" received, except that dividends resulting from specified construction

projects still would be 100% deductible. The existing rules regarding base period amounts and foreign payroll factors that determine the amount of the allowable dividend deduction would be repealed.

This provision would allow a proportionate amount of interest expense attributable to foreign investments to be offset against the deductible dividends.

FISCAL IMPACT

Departmental Costs

By eliminating the complexity of the dividend deduction, this provision may result in some minor cost savings for the department's audit program.

Tax Revenue Estimate

The revenue loss from this provision is estimated to be \$7 million for fiscal year 1996-97, \$10 million for fiscal year 1997-98 and \$12 million for fiscal year 1998-99.

4. LONG-TERM CARE DEDUCTION

EFFECTIVE DATE

This provision would apply to taxable years beginning on or after January 1, 1997.

SPECIFIC FINDINGS

Under both **California and federal law** prior to the Health Insurance Portability and Accountability Act of 1996, enacted on August 21, 1996, no explicit rules are provided for the tax treatment of premiums paid for long-term care insurance contracts or the expenses of long-term care services. The medical expense deduction is limited to expenses paid for the diagnosis, cure, mitigation, treatment, or prevention of disease (including prescription medicines or drugs and insulin). Costs of transportation primarily for, and essential to medical care, as well as medical care insurance premiums, are deductible as medical expenses. These medical expenses are deductible as an itemized deduction to the extent that they exceed a floor of 7.5% of adjusted gross income.

While these deduction limitations remain current California law, newly enacted federal law specifically allows a deduction for medical expenses for the unreimbursed expenses for qualified long-term care services provided to the taxpayer, the taxpayer's spouse or the taxpayer's dependents (subject to the present-law floor of 7.5% of adjusted gross income). Amounts received under a long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other periodic basis) are treated as reimbursement for expenses actually incurred for medical care. Long-term care insurance premiums, like medical care insurance premiums, are explicitly treated

as medical expenses and are deductible on a graduated scale based on the individual's age before the close of the taxable year. This scale ranges from \$200 of premium being treated as medical expenses at age 40 to a maximum of \$2,500 of premium being treated as medical expenses when the individual's age is more than 70.

This provision would conform California law to the new federal provisions which allow a deduction for medical expenses for the unreimbursed expenses of qualified long-term care services provided to the taxpayer, the taxpayer's spouse or the taxpayer's dependents (subject to the present-law floor of 7.5% of adjusted gross income) and would provide that long-term care insurance premiums are explicitly treated as medical expenses.

FISCAL IMPACT

Departmental Costs

This provision of the bill would not significantly impact the department's costs.

Tax Revenue Estimate

This provision results in revenue losses of \$2 million in fiscal year 1996-97, \$9 million in fiscal year 1997-98 and \$10 million in fiscal year 1998-99.

5. MEDICAL SAVINGS ACCOUNTS

EFFECTIVE DATE

This provision would be operative for taxable years beginning on or after January 1, 1997.

SPECIFIC FINDINGS

Under federal law, beginning on January 1, 1997, within limits, contributions to a medical savings account (MSA) are deductible as an adjustment to gross income if made by an eligible individual or excludable from gross income if made by the employer of an eligible individual. Earnings on amounts in an MSA are not taxable prior to distribution, and distributions from an MSA for medical expenses are not taxable.

MSAs are available to individuals covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible plan.

In general, the MSA deduction/exclusions are limited to a maximum of 750,000 taxpayers. Previously uninsured individuals are not taken into consideration in determining whether the cap is reached. After December 31, 2000, generally, no

new contributions may be made to MSAs except for those who were participating in the pilot program.

Under this provision, California would conform to the federal MSA law. The California law would apply only to those individuals in the federal MSA pilot program and filing California returns.

FISCAL IMPACT

Departmental Costs

This provision should not significantly increase departmental costs.

Tax Revenue Estimate

The revenue loss from this provision is estimated to be \$4 million for fiscal year 1996-97, \$8 million for fiscal year 1997-98 and \$10 million for fiscal year 1998-99.

6. SPOUSAL IRAS/CONFORMITY

EFFECTIVE DATE

This provision would apply to taxable years beginning on or after January 1, 1997.

SPECIFIC FINDINGS

Federal law allows individuals to make contributions to IRAs of up to \$2,000 or 100% of compensation, whichever is less (total permitted contribution). In the case of married individuals, each spouse may establish and contribute to an IRA if both spouses have compensation. Special rules apply for individuals with nonworking spouses (see below). A 6% penalty (excise tax) is imposed on contributions in excess of the total permitted contribution.

Generally, individuals can take a deduction for the allowable contributions to IRAs. However, if the individual or spouse is covered by an employer-provided retirement plan at any time during the year, the allowable IRA deduction may be less than the contribution. For such individuals, the deduction may be reduced or eliminated, depending on the individual's filing status and amount of modified adjusted gross income (AGI)¹.

The difference between the total permitted contribution and the total deductible contribution is the nondeductible contribution. Individuals who make nondeductible contributions will have a cost basis in their IRA equal to the amount of those contributions. These nondeductible contributions are not taxed

¹ Modified AGI is AGI figured without taking any IRA deduction, foreign earned income exclusion, foreign housing exclusion or deduction or exclusion of series EE bond interest.

when they are distributed to the individual because they are a return of the IRA investment (i.e., basis).

Nonworking spouse deduction

Recent federal legislation (H.R. 3448, Public Law 104-188) changed the rules for nonworking spouses.

Prior federal law allowed individuals with nonworking spouses to contribute up to \$2,250 or 100% of compensation, whichever was less (total permitted contribution), to a regular and spousal IRA combined. The individual could divide the IRA contributions between the regular IRA and the spousal IRA in any manner, as long as no more than \$2,000 was contributed to either IRA and the aggregate did not exceed the total permitted contribution. For example, the individual could contribute \$1,500 to the regular IRA and \$750 to the spousal IRA.

Public Law 104-188 allows a nonworking spouse to contribute up to the following to an IRA:

- \$2,000, or
- The sum of the compensation includible in the nonworking spouse's gross income for the taxable year, plus the compensation includible in the working spouse's gross income for the taxable year reduced by the amount allowed to the working spouse as a IRA deduction.

California law relating to deductible IRA contributions is in conformity with federal law prior to the recent changes to the deduction for contributions to spousal IRAs. However, prior law differences (years prior to 1976 and 1982 through 1986) have created federal and state basis differences in IRAs. California does **not** impose a penalty (excise tax) on contributions in excess of the total permitted contribution.

This provision would conform to the federal changes to the deduction for contributions to spousal IRAs.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision would result in revenue losses of \$3 million for fiscal year 1996-97, \$8 million for fiscal year 1997-98 and \$9 million for fiscal year 1998-99.

7. **EDUCATION ASSISTANCE EXCLUSION**

EFFECTIVE DATE

This provision would apply to taxable or income years beginning on or after January 1, 1996.

BACKGROUND

Former federal law provided an exclusion from gross income of an employee for amounts paid or incurred by an employer for educational assistance of the employee. The former federal law permitted an exclusion for undergraduate and graduate educational assistance. By its terms, the federal exclusion was not applicable after December 31, 1994. State law conforms to the federal provisions, as in effect in 1993. However, the state provisions do not apply to any taxable year that the federal exclusion is not applicable.

Recently, the **federal law** was retroactively extended to provide an exclusion from gross income, not to exceed \$5,250 per year, for the amount paid or incurred by an employer for educational assistance (including tuition, fees, books, supplies, equipment and other similar expenses) to an employee, for undergraduate courses taken before July 1, 1997, and for both undergraduate and graduate courses taken before July 1, 1996. Thus, the recent extension of the federal provision resulted in an extension of the state exclusion for both graduate and undergraduate courses (in effect as of 1993). With the recent federal extension, state provisions would be effective through May 31, 1997, for courses beginning prior to July 1, 1997, unless other legislative action is taken by the state.

SPECIFIC FINDINGS

Federal law provides an exclusion from gross income for the amounts received for a qualified scholarship by a candidate for a degree at a qualified educational institution. A "qualified scholarship" is the amount received and used for qualified tuition and related expenses, including tuition fees, books, supplies and equipment required for the course of instruction.

Existing state law has adopted the federal exclusion in effect in 1993 for qualified scholarships received by candidates for a degree at a qualified educational institution.

Federal law allows a miscellaneous itemized deduction for employment-related education to the extent the expenses exceed 2% of the taxpayer's adjusted gross income and are incurred to maintain or improve skills required in the taxpayer's business or employment.

Existing state law conforms to the federal law and also allows a deduction for employment-related education to the extent they exceed the 2% floor.

Under federal law, "employee" includes a self-employed individual who has earned income from a trade or business in which personal services of the taxpayer are a

material income-producing factor or an individual who would be "self-employed" except the individual had no net profits for the taxable year.

This bill is based on provisions of the current federal law and would exclude from employee gross income any amounts, not exceeding \$5,250 per calendar year, paid or incurred by the employer for educational assistance to the employee, other than those employees enrolled in any course or education at the graduate level beginning after June 30, 1996. However, the provision is similar to federal law and would create a new provision not conditioned on the existence of a federal provision.

This provision would define "educational assistance" as an employer's payment of expenses incurred by an employee for the employee's education, including but not limited to books, supplies, equipment, tuition, fees, and other similar payments. Educational assistance would not include paying for or providing any tools or supplies that the employee may retain after completing the course instruction, nor any meals, lodging, transportation, any course or other education involving sports, games or hobbies, or any course or education taken at the graduate level beginning on or after June 30, 1996, of a kind normally taken by an individual pursuing a program leading to a law, business, medical, or other advanced academic or professional degree.

This provision would define "educational assistance program" as an employer's separate, written plan to provide educational assistance for the exclusive benefit of his or her employees. "Employee" would include self-employed individuals as defined in federal law. In addition, any person who owned all of an unincorporated trade or business would be considered his own employee. A partnership would be the employer of each partner.

The educational assistance program would be required to meet requirements, including:

- Benefiting employees who qualify under an employer classification that does not discriminate in favor of highly compensated employees nor their dependents, as determined by the FTB.

The educational assistance program would not fail to meet the requirements merely because:

- Different rates are used for different types of educational assistance; or
- Reimbursement under the program would be dependent on successful completion of a course or attaining a particular course grade.

This provision would not affect the deduction or inclusion of income from amounts paid, incurred or reimbursed for educational expenses under federal law.

This provision would specify that no other deduction or credit would be allowed regarding any amount excluded from income by this section.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue impacts from this provision are estimated to be a revenue increase of \$7 million and \$3 million for fiscal years 1996-97 and 1997-98 respectively, and a revenue loss of \$7 million for fiscal year 1998-99.

8. MINIMUM FRANCHISE TAX

EFFECTIVE DATE

This provision would apply to income years beginning on or after January 1, 1997.

BACKGROUND

The minimum franchise tax was established to ensure that all banks or corporations pay at least a minimum amount of franchise tax for the privilege of doing business in this state, regardless of the bank's or corporation's level of income (or loss). For taxable years beginning before January 1, 1989, the minimum franchise tax was \$300. This tax was increased (SB 572, Stats. 1987, Ch. 1139) to \$600 for taxable years beginning on or after January 1, 1989, and before January 1, 1990, and to \$800 for taxable years beginning on or after January 1, 1990. The minimum franchise tax is \$25 for certain gold and quicksilver mining corporations. Credit unions and certain nonprofit cooperative associations are not subject to the minimum franchise tax.

Taxpayers are required to pay the minimum franchise tax for their first taxable year to the Secretary of State at the time they incorporate (California corporation) or initially register with that office to do business in this state (non-California corporation). This initial payment constitutes the taxpayer's initial return. Because the taxpayer has no prior income year on which to measure the tax, the only tax due for the first taxable year is the prepaid minimum franchise tax of \$800. However, prepayment of the second year's minimum tax is due during the first year. At the end of the first year, even if it is not a full 12 months, taxpayers are required to compute their franchise tax for the privilege of conducting business during the second taxable year based on a measurement of the first year's net income. The taxpayer must file a corporate franchise tax return within two months and 15 days after the end of the first income year and include with that return payment of the taxes due for the second taxable year. The franchise tax for each subsequent taxable year is computed based on a measurement of the preceding year's net income. Under the rules for payment of estimated taxes, four equal payments are to be made during the current year for the privilege of exercising a corporate franchise in the subsequent year, but the first payment cannot be less than the \$800 minimum tax.

SPECIFIC FINDINGS

Under existing state B&CTL, every bank and corporation that is qualified to do business or is doing business in this state (whether organized in-state or out-of-state) is subject to the minimum franchise tax. Taxpayers must pay the minimum franchise tax only if it is more than their measured bank or corporation tax. Currently, only taxpayers whose net income is less than approximately \$8,600 pay the minimum franchise tax because their measured tax would be less than \$800 ($\$8,600 \times 9.3\% = \799).

Existing state law provides that real estate mortgage investment conduits (REMICs), regulated investment companies (RICs), and real estate investment trusts (REITs) are subject to and required to pay the minimum franchise tax.

Existing state law requires nonprofit charitable organizations to file periodic reports with the Attorney General. In any year a nonprofit charitable organization does not file with the Attorney General and the Attorney General notifies the department of this failure, the nonprofit charitable organization is assessed and required to pay the minimum franchise tax.

Also **under existing state law**, the tax on limited partnerships (LPs), limited liability companies (LLCs), and limited liability partnerships (LLPs) is set at \$800 by reference in the code to the amount provided in the bank and corporation minimum franchise tax statute.

This provision would provide a reduced minimum franchise tax of \$600 for "qualified new corporations" with gross receipts, less returns and allowances, reportable to this state of less than \$1 million. The reduced tax would apply only to the first taxable year commencing on the date the corporation is incorporated.

This provision also would provide that the determination of whether a corporation meets the gross receipts criterion would be based on the aggregate gross receipts of the members of a commonly controlled group. The bill defines "gross receipts less returns and allowances reportable to this state" as including both business and nonbusiness receipts.

The provision would not apply to any corporation if 50% or more of its stock is owned by another corporation. In addition, it would not apply to LPs, LLCs, LLPs, REMICs, RICs, REITs, and charitable corporations that are required to pay the minimum franchise tax as a result of failure to file with the Attorney General.

The corporation would pay an additional tax of \$200 on the due date of its first return, without regard to extension, if the corporation's gross receipts exceed \$1 million or its tax liability exceeds \$800.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue loss from this provision is estimated to be \$6 million for fiscal year 1996-97, \$8 million for fiscal year 1997-98, and \$5 million for fiscal year 1998-99.

9. ESOPS CONFORMITY

EFFECTIVE DATE

This provision would apply to taxable or income years beginning on or after January 1, 1996.

SPECIFIC FINDINGS

Existing federal law, after the enactment of the Small Business Job Protection Act of 1996, provides special tax rules for the purchase of employer securities by the employees of the issuing company. These special tax rules are as follows:

- An employee stock ownership plan must be established by the employer. The employer corporation is entitled to a deduction for dividends paid to the ESOP, provided that amount is in turn paid by the ESOP to its participants or used to repay an ESOP loan. Contributions by the employer to an ESOP that are used to repay loans incurred to purchase employer stock may be deducted as long as they do not exceed 25% of the total compensation paid to participants.
- When the stock of a domestic corporate employer is closely held (that is, the corporation has no stock outstanding that is readily tradable on an established securities market), federal law allows shareholders to sell the stock to an ESOP and to roll-over the gain into other corporate stock acquired with the proceeds from the sale. Gain may be deferred in this manner so long as immediately after the sale to the ESOP, the ESOP owns at least 30% of the closely held employer's stock and within 15 months the seller purchases "qualified replacement securities" (which include stock, stock rights, bonds and debentures) in a domestic corporation. This deferral does not apply to gain includible in the gross income of any C corporation.

The state provisions that conformed to these two rules apply only to taxable (and income) years beginning before January 1, 1995. Therefore, there is no special treatment in current state law with respect to ESOPs.

This provision would reenact the state's former conformity to these two rules for taxable and income years beginning on or after January 1, 1996, and indefinitely thereafter.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue loss from this provision is estimated to be \$6 million for fiscal year 1996-97, \$4 million per fiscal year 1997-98 and 1998-99.

10. MANUFACTURERS' INVESTMENT TAX CREDIT/AEROSPACE CLEAN-ROOMS/NET OPERATING LOSS/MANUFACTURER LESSORS

Manufacturers' Investment Credit

EFFECTIVE DATE

The changes regarding the aerospace industry would apply to taxable or income years beginning on or after January 1, 1996. The other substantive changes in this provision would apply to taxable or income years beginning on or after January 1, 1997. However, this provision specifies that the clarification regarding pass-through entities in the MIC is declaratory of existing law.

SPECIFIC FINDINGS

Existing state law, under both the PITL and the B&CTL, allows qualified taxpayers a credit equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California. This credit is known as the Manufacturers' Investment Credit (MIC).

This credit defines "qualified taxpayer" as any taxpayer engaged in manufacturing activities described in Codes 2000 through 3999 of the Standard Industrial Classification (SIC) Manual.

Under this credit, "qualified property" is:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code and used by a qualified taxpayer primarily:

- for manufacturing, processing, refining, fabricating or recycling of property;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control which meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) Special purpose buildings and foundations that are an integral part of manufacturing, refining, processing or fabricating, or research and storage facilities that are part of the process, which are used by qualified persons performing manufacturing activities described in specific codes relating to computer, accounting and office machines, electronic equipment and accessories, and biotech or biopharmaceutical activities.

This credit explicitly excludes certain types of property from the definition of qualified property and provides a variety of definitions. The credit defines "biopharmaceutical activities" as performing activities relating to providing pharmaceutical products for human or animal therapeutics and diagnostics.

Taxpayers engaged in biopharmaceutical activities must be described in SIC Codes 2830 to 2836. This credit does not define "biotechnology activities" other than requiring the activities to fall within SIC Code 8731.

This credit provides special rules for costs paid pursuant to a binding contract and leased property. The credit may be carried over until exhausted for a maximum of eight years. For small businesses, this carryover is extended to ten years. The taxpayer must recapture any credit previously allowed if the property is removed from California, disposed of to an unrelated party or converted to an unauthorized use within one year from the date the property is first placed in service in California.

Certain "new businesses" (as defined) may claim an exemption from sales and use tax instead of this tax credit. The existing sales and use tax law also allows a taxpayer to claim a refund for the sales or use tax that was paid on the purchase of qualified property rather than claiming the MIC, although this refund provision only allows the refund to be made in the same amounts and at the same time as the MIC could have been claimed for income or franchise tax purposes.

This provision would add taxpayers engaged in semiconductor equipment manufacturing as described in SIC Code 3559 to the existing law provision which allows certain taxpayers to claim the MIC with respect to their qualified costs for their special purpose buildings.

This provision also would add taxpayers engaged in certain aerospace manufacturing to the special purpose building language. These manufacturers would be those involved in activities relating to space vehicles and parts as described in SIC Codes 3761 (Guided Missiles and Space Vehicles), 3764 (Guided Missile and Space Vehicle Propulsion Units and Propulsion Unit Parts), 3769 (Guided Missiles and Space Vehicle Parts and Auxiliary Equipment), or space satellites, communications satellites and equipment as described in SIC Codes 3663 (Radio and Television Broadcasting and Communications Equipment) and 3812 (Search, Detection, Navigation, Guidance, Aeronautical, and Nautical Systems and Instruments).

This provision would add to the definition of "small business" in the MIC taxpayers engaged in certain biopharmaceutical and biotechnology activities and who have not received regulatory approval for any product. Thus, these taxpayers would be allowed an extended carryover period of 10 years, instead of 8 years, irrespective of whether they otherwise would be treated as a "small business" under the MIC. Taxpayers engaged in biopharmaceutical activities as currently defined in the MIC would qualify as small businesses.

This provision also would add a definition for biotechnology activities as those activities in SIC Codes 2833 to 2836 which relate to recombinant DNA and pharmaceutical delivery systems. Neither the biopharmaceutical or biotech taxpayers may have received federal regulatory approval for any product to qualify for this special treatment.

This provision would make minor technical amendments to the MIC, namely:

- add a definition of "process" which duplicates the definition in the Board of Equalization regulations and the proposed FTB regulations;
- delete non-existent codes from the list of qualifying SIC Codes;
- clarify that the qualified taxpayer determination is made at the entity level for pass-through entities and that the credit allowed would be passed through to the partners or shareholders, irrespective of whether the partners or shareholders themselves would be treated as a qualified taxpayer;
- authorize the FTB to prescribe regulations to ensure that the purpose of this credit is accomplished; and
- delete grammatically unnecessary words.

This provision would allow a taxpayer who is both a manufacturer and lessor of tangible personal property which would qualify for the MIC to pay sales tax on that property. The property would have to be leased to a qualified person as defined in the MIC. Thus, this bill would allow a lessee of qualified property leased from a manufacturer/lessor to claim the MIC where before the leased property did not qualify because sales tax had not been paid.

This provision would specify that the election to pay the sales tax would be in lieu of reporting use tax measured by the rentals payable. The election would be made by reporting use tax measured by the cost price on the sales tax return for that period. The election may not be revoked. This provision also would define "cost price."

Net Operating Loss

EFFECTIVE DATE

These provisions would apply to taxable or income years beginning on or after January 1, 1997.

SPECIFIC FINDINGS

The **existing PITL and B&CTL** conform, with significant modifications, to the federal provisions covering NOLs which occur when a taxpayer's business expenses exceed income. For federal purposes, an NOL can be carried back to the three preceding years and carried forward for 15 years.

California does not allow the NOL deduction to be carried back and generally allows only 50% of the NOL to be carried forward for five years. However, special rules apply to specific groups of taxpayers, namely:

- Taxpayers operating a "new business" formed after January 1, 1994, are allowed a 100% carryforward for losses attributable to the new business incurred in their first three years of business. The losses incurred in their first, second, and third years of business may be carried forward for eight, seven, and six years, respectively.
- Taxpayers operating a "small business" with receipts of less than \$1 million may carry forward 100% of the loss attributable to the small business for five years.
- Certain taxpayers in bankruptcy and certain bankruptcy reorganizations may carry forward 50% of their loss for ten years.

The NOL provisions are allowed indefinitely.

This provision would amend the NOL laws to include certain taxpayers engaged in biopharmaceutical and biotechnology activities under the definition of "new business." Taxpayers would have to be engaged in biopharmaceutical or biotechnology activities described in SIC Codes 2833 to 2836 and not have received any regulatory approval for any product. Biopharmaceutical taxpayers that perform activities relating to providing pharmaceutical products for human or animal therapeutics and diagnostics and biotechnology taxpayers that perform activities relating to recombinant DNA and pharmaceutical delivery systems would qualify as a "new business." As a result, these existing biopharmaceutical and biotechnology companies would be able to carry over 100% of their NOLs incurred in their first three years of operation starting January 1, 1997, for eight years, seven years, and six years respectively.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision would have an impact of \$0 for fiscal year 1996-97 and revenue losses of \$2 million for fiscal year 1997-98 and \$6 million for fiscal year 1998-99.

11. AEROSPACE/ENTERPRISE ZONE HIRING CREDIT

EFFECTIVE DATE

This provision would apply to taxable or income years beginning on or after January 1, 1996.

SPECIFIC FINDINGS

State law provides a hiring credit to enterprise zone employers for wages paid to specific individuals. A credit is allowed for the taxable or income year equal to the sum of each of the following qualified wages (not to exceed 150% of minimum wage, which currently equates to \$6.37²) paid to a "qualified disadvantaged individual":

- 50% for the first year of employment;
- 40% for the second year of employment;
- 30% for the third year of employment;
- 20% for the fourth year of employment;
- 10% for the fifth year of employment.

A "qualified disadvantaged individual" is defined as a "qualified employee" who is hired by the employer after the zone has been designated. The individual must be any one of the following: (1) eligible for services under the federal Job Training Partnership Act (JTPA) and receiving, or eligible to receive, employment training or services under the JTPA program; (2) eligible to be a voluntary or mandatory registrant under the Greater Avenues for Independence Act of 1985; or (3) eligible as determined by the California Employment Development Department (EDD) under the federal Targeted Jobs Tax Credit Program. (Employment priority is given to qualified disadvantaged individuals in a state or federal jobs program over those eligible for a program.) A "qualified employee" means an individual who provides at least 90% of his or her services which are directly related to the taxpayer's business located in the zone and performs at least 50% of his or services in the zone.

The amount of the credit claimed in any year may not exceed the amount of tax on that year's zone income. The credit must be reduced by any federal or state jobs credit that was allowed. The business also must reduce any deduction for wages by the amount of this credit. Any unused credit may be carried over and applied against the tax imposed on zone income in the future. No credit can be claimed for wages paid on or after the date the enterprise zone designation expires or is no longer binding.

This provision would increase the maximum amount of certain qualified wages eligible for the hiring credit from 150% to 202% of the minimum wage (\$6.37 to \$8.58). This increase would apply for up to 1,350 qualified employees employed by the taxpayer in the Long Beach Enterprise Zone in aircraft manufacturing

² This analysis does not take into account recent legislation which increased the minimum wage.

activities described in Codes 3721 to 3728, inclusive, and 3812 of the Standard Industrial Classification (SIC) Manual.

Implementation Consideration

If this bill and AB 296 or SB 2023 are enacted, for taxable or income years beginning on or after January 1, 1997, two or three enterprise zone hiring credits would exist. This could provide certain taxpayers double benefits. Department staff understands that clean-up legislation will be sought to eliminate the double, or triple, incentives.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue loss from this provision is estimated to be \$2.7 million per fiscal year for fiscal years 1996-97, 1997-98 and 1998-99.

12. CORPORATE CHARITABLE CONTRIBUTIONS DEDUCTION

EFFECTIVE DATE

This provision would apply to excess contributions made during income years beginning on or after January 1, 1996.

SPECIFIC FINDINGS

Under current federal law, the total deductions allowed for charitable contributions of a bank or corporation for any taxable year may not exceed 10% of the taxpayer's net income (except as specified). Contributions in excess of 10% may be carried over to the five succeeding taxable years.

Under current state law, the total deductions allowed for charitable contributions of a bank or corporation for any income year may not exceed 5% of the taxpayer's net income computed as specified. No carryover provisions for excess contributions apply.

This provision would increase the bank and corporation charitable contribution deduction limit from 5% to 10% of a taxpayer's net income.

This provision would allow any excess contributions over the bank and corporation charitable contribution deduction limit to be carried over to offset the taxpayer's income for up to five future years.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue loss from this provision of the bill is estimated to be \$3 million for fiscal year 1996-97 and \$2 million per fiscal year for the 1997-98 and 1998-99 fiscal years.

13. ENHANCED OIL RECOVERY CREDIT

EFFECTIVE DATE

This provision would apply to taxable and income years beginning on or after January 1, 1996.

SPECIFIC FINDINGS

Federal law allows taxpayers an enhanced oil recovery credit which is combined with several other credits to form the general business credit. This credit is 15% of the taxpayer's qualified enhanced oil recovery costs, which are defined as amounts paid or incurred for qualifying tangible property which is depreciable or amortizable and an integral part of a qualified enhanced oil recovery project, qualifying tertiary injectant costs, and qualifying intangible drilling and development costs.

The **enhanced oil recovery credit** is allowed on costs connected to a qualified enhanced oil recovery project which involves the application of a tertiary recovery method that is expected to result in a significant increase in the amount of crude oil recovered. This project must be certified by a licensed petroleum engineer.

Federal law provides that any otherwise allowable deduction for the costs used to calculate the credit must be reduced by the amount of the credit. Also, if any qualifying costs would increase the basis in any property, after the increase the basis must be reduced by the amount of the credit to reflect the qualifying costs.

The **enhanced oil recovery credit** is phased-out based on the average per barrel wellhead price of domestic crude oil. This phase-out is adjusted annually for inflation and does not apply to the credit calculation for the 1993 or 1994 years.

The **enhanced oil recovery credit** is available for costs paid or incurred in taxable or income years beginning on or after January 1, 1991, and does not contain a sunset date.

California law does not currently conform to the enhanced oil recovery credit. Expenses used to calculate the federal credit would be deductible for state purposes as trade or business expenses or as a depreciation or amortization deduction.

Existing California law provides general rules for the division of credits which apply unless the individual credit law specifies different rules. If two or more taxpayers (other than husband and wife) share in the costs used as the basis of the credit, each taxpayer is eligible to receive the tax credit in proportion to his or her respective share of the costs. A husband and wife who file separate returns either may equally divide the credit or allow one spouse to claim the entire credit. In the case of a partnership, the credit is computed at the partnership level and may be divided among the partners pursuant to a written partnership agreement in accordance with IRC Section 704.

Under the PITL and the B&CTL, **this provision** would add an enhanced oil recovery credit to California law. The credit amount would be one-third of the taxpayer's allowed federal enhanced oil recovery credit (rather than the amount allowed by the general business credit, which is subject to limitations). The state credit would apply only to oil recovery projects located within California. The provision of federal law which requires any allowable deduction to be reduced by the amount of the credit and the property's basis to be reduced in certain circumstances would apply for state purposes.

This provision would specify that if the taxpayer has elected not to take the credit for federal purposes, for state purposes the amount of the federal credit would be zero and therefore the taxpayer would not be allowed a state credit. Also, if property qualifies for both this oil credit and any other credit, such as the MIC, the taxpayer would not be able to claim both credits on the same property.

This provision would specify that the credit may not be claimed if the taxpayer would not qualify for a specified depletion allowance under federal law. Essentially, retailers, certain related parties, and refineries whose output exceeds 50,000 barrels on any day of the year would be excluded.

This provision would specify that the credit may be carried over for 15 years. This credit may not reduce the tax below tentative minimum tax for AMT purposes.

The general rules in California law regarding division of credits would apply since **this provision** does not designate different rules.

FISCAL IMPACT

Departmental Costs

This provision should not significantly impact the department's costs.

Tax Revenue Estimate

This provision would result in revenue losses of \$2 million per fiscal year for fiscal years 1996-97, 1997-98 and 1998-99.

14. ALTERNATIVE MINIMUM TAX

EFFECTIVE DATE

This provision would apply to taxable or income years beginning on or after January 1, 1996.

BACKGROUND

In 1987, California enacted legislation that established an AMT in lieu of the previous tax on preference income. The California legislation substantially conformed state law to the federal AMT provisions, which had been adopted as part of the Tax Reform Act of 1986. The AMT at both the federal and state levels was established to ensure that no taxpayers with substantial economic income avoid all tax liability by using exclusions, deductions, and credits (tax preference items).

SPECIFIC FINDINGS

Existing federal law provides a graduated personal income AMT rate of 26% for the first \$175,000 of "taxable excess" and 28% of the amount exceeding \$175,000 of "taxable excess." "Taxable excess" is defined as the amount of alternative minimum taxable income for the taxable year that exceeds the exemption amount. **Federal law** provides a corporate AMT rate of 20% of that portion of the alternative minimum taxable income as exceeds the exemption amount. Exemption amounts are \$45,000 for taxpayers filing a joint return or surviving spouses; \$33,750 for taxpayers filing single; \$22,500 for married taxpayers filing a separate return and estates and trusts; and \$40,000 for corporate taxpayers.

Existing state law provides a personal income AMT rate of 7%. This tax rate is applicable to taxable years beginning on or after January 1, 1996. For taxable years beginning on or after January 1, 1991, and before January 1, 1996, the personal income AMT rate is 8.5%. The corporate AMT rate also is set at 7%. The **state** personal income exemption amounts are \$40,000 for married taxpayers filing joint returns; \$30,000 for individuals filing as either single or as a head of household; and \$20,000 for married taxpayers filing separate returns. For corporate taxpayers, the **state** exemption amount is \$40,000.

Under the AMT, taxable income (or net income for corporations) essentially is recalculated without benefit of any of the regular tax preferences; the resulting tax is the tentative minimum tax (TMT). The AMT can affect taxpayers in two ways. First, an AMT liability is imposed if the TMT is calculated to be greater than the taxpayer's regular tax (the AMT is the difference between regular tax and TMT). Second, certain credits (including, for individuals, the personal exemption credit) may be limited because they cannot be used to reduce regular tax below the TMT.

This provision, under the PITL, would provide that any trade or business income of a qualified taxpayer would not be subject to AMT. A qualified taxpayer would be defined as a taxpayer who is an owner of or has an interest in a trade or business with aggregate gross receipts of less than \$1 million. A taxpayer's proportionate interest in a pass-through entity would be included in the gross receipts test.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision would result in revenue losses of \$2 million per fiscal year for fiscal years 1996-97, 1997-98 and 1998-99.

15. DISCHARGE OF INDEBTEDNESS

EFFECTIVE DATE

This provision would apply to discharges occurring on or after January 1, 1996, in taxable or income years beginning on or after January 1, 1996.

A: Discharge of Qualified Real Property Business Indebtedness Income

PROGRAM BACKGROUND

In general, a taxpayer realizes income by the discharge of indebtedness to the extent the debt was canceled or forgiven. Included in the meaning of a debt is any indebtedness for which a taxpayer is liable or any debt that attaches to property held by the taxpayer. A debt that is restructured and results in a reduction of the liability is considered a discharge of indebtedness to the extent of the reduction, subject to statutory exceptions.

SPECIFIC FINDINGS

Existing federal law allows an exclusion from gross income of indebtedness discharged when taxpayers are insolvent or in bankruptcy. In addition, as a result of enactment of the federal Revenue Reconciliation Act of 1993, federal law allows taxpayers, other than C corporations, to elect to exclude from gross income certain income resulting from the discharge of qualified real property business indebtedness. The election must be made on the taxpayer's original return for the year in which the exclusion is claimed. The amount excluded cannot exceed the basis of certain depreciable real property of the taxpayer. Also, the excluded amount reduces the basis of the property.

Federal law defines qualified real property business indebtedness as indebtedness:

- 1) that is incurred or assumed in connection with real property used in a trade or business;
- 2) that is secured by that real property;
- 3) that is incurred or assumed either:
 - (a) before January 1, 1993, or
 - (b) to acquire, construct, reconstruct, or substantially improve that real property, and
- 4) for which the taxpayer has made a valid election under these federal provisions.

Under **federal law**, the amount excluded may not exceed the excess of (1) the outstanding principal amount of such debt (immediately before the discharge) over (2) the fair market value (at the time of discharge) of the real property that is security for the debt. For this purpose, the fair market value of the property is reduced by the outstanding principal amount of any other qualified real property indebtedness secured by the property immediately before the discharge. Also, the amount excluded may not exceed the adjusted basis (determined as of the first day of the next tax year, or if earlier, the date of disposition) of depreciable real property held by the taxpayer immediately before the discharge, determined after any basis reductions under insolvency or bankruptcy rules (which take precedence). The amount of excluded indebtedness is applied to reduce the basis of business real property held by the taxpayer at the beginning of the tax year following the discharge. Thus, the amount excluded would, in most cases, eventually be included in income (recaptured) because the taxpayer would claim smaller depreciation deductions over the time the asset is held, or because the taxpayer would realize a larger gain on disposition of the asset.

Existing state law has not conformed to this 1993 federal change. As a result, California taxpayers currently must include in gross income any income from the discharge of qualified real property indebtedness which does not otherwise qualify for an exclusion under other discharge of indebtedness rules.

This provision would conform the PITL and the B&CTL to federal treatment of income from the discharge of qualified real property business indebtedness. This provision of the bill would require consistent state and federal elections for this exclusion by specifying that the federal election, or lack thereof, would be binding for state purposes.

B: Repeal of the Stock-For-Debt Exception

PROGRAM BACKGROUND

Gross income generally includes cancellation of indebtedness (COD) income. However, taxpayers in Title 11 cases and insolvent taxpayers generally exclude COD income from gross income, but reduce tax attributes by the amount of COD income. The amount of COD income that an insolvent taxpayer excludes cannot exceed the amount by which the taxpayer is insolvent.

The amount of COD income generally is the difference between the adjusted issue price of the debt being canceled and the amount of cash and the value of any property used to satisfy the debt. Thus, for purposes of determining the amount of COD income of a debtor corporation that transfers stock to a creditor in satisfaction of its indebtedness, the corporation is generally treated as realizing COD income equal to the excess of the adjusted issue price of the debt over the fair market value of the stock. Prior to the federal Revenue Reconciliation Act of 1993, however, if the debtor corporation was in a Title 11 case or was insolvent, the excess of the debt discharged over the fair market value of the transferred stock generally did not constitute federal COD income (the "stock-for-debt exception"). Thus, a corporate debtor that qualified for the stock-for-debt exception was not required to reduce its tax attributes as a result of the debt discharge. The stock-for-debt exception did not apply to the issuance of certain preferred stock, nominal or token shares of stock, or stock issued to unsecured creditors on a relatively disproportionate basis. In the case of an insolvent debtor not in a Title 11 case, the exception applied only to the extent the debtor was insolvent.

SPECIFIC FINDINGS

Existing federal law provides that when a debtor corporation that is insolvent or in bankruptcy transfers its stock in satisfaction of its indebtedness, that transfer must be treated as if the corporation satisfied the indebtedness with an amount of money equal to the fair market value of the stock that had been transferred.

Existing state law has not conformed to the 1993 federal change. As a result, California still provides the stock-for-debt exception.

This provision would conform the PITL and the B&CTL to the changes made to federal law by the Revenue Reconciliation Act of 1993 that repealed the stock-for-debt exception in determining income from discharge of indebtedness.

C: Tax Attributes That Are Reduced in a Discharge of Indebtedness Situation

SPECIFIC FINDINGS

1. **Under existing federal law**, the discharge of indebtedness generally gives rise to gross income to the debtor taxpayer. Present law provides exceptions to this general rule. Among the exceptions are rules providing that income from the discharge of indebtedness of the taxpayer is excluded from income if the discharge occurs in a Title 11 case, the discharge occurs when the taxpayer is insolvent, or in the case of certain farm indebtedness. The amount excluded from income under these exceptions is applied to reduce tax attributes of the taxpayer. The tax attributes reduced (in order) are:

- 1) net operating losses and carryovers;
- 2) general business credit carryovers;

- 3) minimum tax credits as of the beginning of the taxable year immediately after the taxable year of the discharge;
- 4) net capital losses and capital loss carryovers;
- 5) the basis of certain property of the taxpayer;
- 6) passive activity loss and credit carryovers from the taxable year of the discharge; and
- 7) foreign tax credit carryovers.

The amount of the reduction is generally one dollar for each dollar excluded, except that the reduction in the case of credits is 33 1/3 cents for each dollar excluded.

Existing state law generally conforms, by reference, to **federal law** with certain modifications to substitute state credits for federal credits and to adjust for the difference in the rates of tax. However, **state law** has not conformed to the 1993 federal changes that added to the list of tax attributes against which amounts excluded from gross income are applied. As a result, for **state law**, minimum tax credits and passive activity losses and credits are not tax attributes that are reduced under the rule relating to exclusion of discharge of indebtedness income.

This provision would conform the PITL and the B&CTL to the 1993 changes to federal law that added minimum tax credits and passive activity losses and credits to the list of tax attributes that are reduced under the rule relating to exclusion of discharge of indebtedness income.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

The fiscal impact from this provision is estimated to be a revenue loss of \$3 million for fiscal year 1996-97, a revenue gain of \$2 million for fiscal year 1997-98 and a revenue gain of \$4 million for fiscal year 1998-99.

16. FARMWORKER HOUSING CREDIT

EFFECTIVE DATE

This provision would apply to taxable or income years beginning on or after January 1, 1997.

Credit For Construction Or Rehabilitation Of Farmworker Housing

SPECIFIC FINDINGS

Existing federal law allows owners of residential rental projects that provide low-income housing to claim the federal low-income housing credit as a component of the general business credit for qualified low-income buildings placed in service after 1986. This credit is claimed over a ten-year period, beginning with either the year the building is placed in service or, if the taxpayer chooses, the following year.

Current California law allows a credit for 30% of costs paid or incurred for the purchase of, or improvements to, low-income housing if a project meets the federal low-income housing rules, subject to certain state modifications. The state credit is taken over a three-year period. Credits in excess of the taxpayer's net tax may be carried forward until exhausted.

Under the PITL and the B&CTL, this provision would allow a credit for 50% of the qualified amount of the costs paid or incurred for construction or rehabilitation of qualified farmworker housing. The qualified amount would equal the sum of (1) all costs paid or incurred on or after January 1, 1997, to construct or rehabilitate farmworker housing to meet the requirements of the Employee Housing Act; and (2) general improvement costs incurred on or after January 1, 1997, including, but not limited to, improvements to ensure compliance with laws governing access for persons with disabilities and costs related to reducing utility expenses.

The aggregate amount of credits granted for both PITL and B&CTL taxpayers and for banks and financial corporations for foregone interest on farmworker housing loans can not exceed \$500,000 for any taxable or income year. However, in 1998 and subsequent years, the credits could exceed \$500,000 per calendar year by an amount equal to any unallocated credits from the preceding calendar year(s). The credit would not be allowed unless the taxpayer constructs or rehabilitates the property subject to the covenants, conditions and restrictions imposed by the provisions of the Revenue and Taxation Code (R&TC) and pursuant to the Farmworker Housing Assistance Program. Further, the credit would not be allowed until the first taxable or income year during which the construction or rehabilitation is complete and occupied by eligible farmworkers.

The taxpayer would be required to: (1) obtain credit certification from the California Tax Credit Allocation Committee (Committee) prior to paying or incurring costs; (2) retain a copy of the certification; and (3) provide the certification to the FTB upon request.

The Committee would be required to: (1) provide forms and instructions for application for credit certification; (2) accept applications and issue a certificate to the taxpayer verifying the amounts that qualify for the credit and allocating the total amount of the credit to which the taxpayer is entitled for the taxable or income year; (3) obtain the taxpayer's tax identification number for tax administration purposes; and (4) provide an annual listing to FTB in a

manner agreed upon by FTB and the Committee, comprised of the names, taxpayer identification numbers, qualified expenditures and total amount of credit certified to each taxpayer.

If the credit certification were obtained by fraud or misrepresentation, the entire amount of the credit previously allowed (as well as the applicable interest amount, as defined) would be added to the taxpayer's tax in the taxable or income year in which the fraud or misrepresentation is identified. If a taxpayer failed to comply with the requirements of the Employee Housing Act, the Farmworker Housing Assistance Program or any other requirements contained within the tax credit section, a prorated amount of the credit previously allowed would be added to the taxpayer's tax liability.

This provision would define "qualified year," "qualified amount," "compliance period," "construct or rehabilitate," "Employee Housing Act," "Farmworker Housing Assistance Program," "qualified farmworker housing," "committee," "qualified accountant," "disqualifying event," "recapture amount," and "interest amount".

This provision would prohibit the allowance of any other deduction or credit to the extent that any qualified amounts, as defined, are considered in computing the amount of the credit certified to each taxpayer. Credit amounts would be carried over to reduce tax liabilities in succeeding years until exhausted.

Credit For Interest Income On Farmworker Housing Loans

SPECIFIC FINDINGS

Under existing federal and state law, no credits are allowed for foregone interest income comparable to the credit proposed by this bill.

Under the B&CTL, this provision would provide a credit equal to the qualified amount of interest income, as defined, on a loan used to finance the construction or rehabilitation of qualified farmworker housing. The qualified amount would equal 50% of the difference between the amount of interest income that could have been collected by the bank or financial corporation had the loan been one point above prime, or by other index used by the lender, and the lesser amount of interest income actually due for the term of the loan.

The aggregate amount of the credits granted by the Committee under this provision and for qualified amounts paid or incurred to construct or rehabilitate qualified farmworker housing would not exceed \$500,000 for any income year. However, in 1998 and subsequent years, the credits could exceed \$500,000 per calendar year by an amount equal to any unallocated credits from the preceding calendar year(s). The credit would apply to loans for financing qualified expenditures paid or incurred to construct or rehabilitate farmworker housing. The credit would be taken in equal installments over a period equal to the lesser of 10 years or the term of the loan beginning in the taxpayer's income year during which the qualified farmworker housing is completed and there is initial occupancy by eligible farmworkers. Any excess credit could not be carried over to succeeding years.

The credit would not apply to a loan with a term of less than three years or to a loan funded prior to January 1, 1997. Further, the credit would only apply to interest income from the loan and not to any other loan fees or charges with respect to the loan.

The taxpayer/lender would be required to obtain credit certification and allocation from the Committee prior to funding the loan. The taxpayer/lender would retain the certificate and present it to FTB upon request.

The Committee would be required to accept applications, issue certifications, obtain taxpayer identification numbers and provide FTB with an annual listing of taxpayers, in a form and manner agreed upon by FTB and the Committee. The list should contain the names, taxpayer identification numbers, qualified amounts, and total amount of credit allocated to each taxpayer.

If the bank or financial corporation were to sell the loan to another bank or financial institution, the credit would be passed to the new institution, unless the original bank or financial corporation retained service responsibilities for the loan.

If the credit certification were obtained by fraud or misrepresentation, the entire amount of the credit previously allowed (as well as the applicable interest amount, as defined) would be added to the taxpayer's tax in the income year in which the fraud or misrepresentation occurs.

This provision would provide that if the Treasurer of the United States or a court of competent jurisdiction determined that the preferential treatment of farmworker housing loans is a discriminatory tax, the committee could not allocate any more credits. However, credits already allocated would remain valid.

FISCAL IMPACT

Departmental Costs

Because the Committee is responsible for certifying and allocating credit amounts and reporting the information to FTB, the provisions of this bill are not anticipated to significantly increase the department's costs.

Tax Revenue Estimate

The credit for construction or rehabilitation of farmworker housing and the credit for the foregone interest income on farmworker housing loans have a combined aggregate credit amount of \$500,000. These provisions would result in a revenue loss of \$500,000 per fiscal year for fiscal years 1996-97, 1997-98 and 1998-99.

17. RICE STRAW CREDIT

EFFECTIVE DATE

This provision would apply to taxable or income years beginning on or after January 1, 1997, and before January 1, 2008.

SPECIFIC FINDINGS

Federal law and state laws contains a variety of provisions specifically relating to farmers and agriculture. These provisions include special accounting and inventory methods, certain income deferral conditions, capital gain-ordinary loss treatment, the deduction of items normally capitalized, and exempt status for labor, agricultural, or horticultural organizations.

Existing federal and state laws provide various tax credits that are designed to provide tax relief for taxpayers who incur certain expenses (e.g., child and dependent care credits) or to influence behavior, including business practices and decisions (e.g., research credits, enterprise zone or program area hiring credits). These credits provide incentives for businesses to perform actions which they may not otherwise do, may not do at the desired location, etc.

Except as specified, **state law** does not allow any tax credit to reduce regular tax below the tentative minimum tax for purposes of the AMT calculation.

This provision would create a tax credit equal to \$15 for each ton of rice straw purchased by the taxpayer that was grown in California. The credit would be limited to an aggregate annual amount, as computed under PITL and B&CTL provision, of \$400,000. By reference to the Health and Safety Code, this bill defines "rice straw" as the dry stems of cereal grains left after the seed heads have been removed.

The Department of Food and Agriculture (DFA) would be responsible for allocating this credit. The DFA would be required to:

- certify that the taxpayer has purchased the rice straw;
- issue certificates on a "first come, first served" basis and in an aggregate amount not to exceed certain limits;
- provide an annual listing to the FTB of the taxpayers who were issued certificates and the amount of rice straw purchased by each taxpayer;
- provide the taxpayer with a copy of the certification;
- obtain the taxpayer's identification number, including the numbers of all partners in a partnership and all shareholders in an S corporation; and
- report to the Legislature annually on the number of credit certificates requested and issued, the type of businesses receiving credits, the methods used to process the rice straw, and recommendations to maximize the long-term use of California rice straw.

This bill would require the taxpayer to:

- provide DFA with documentation to verify the purchase of rice straw;
- provide DFA with the necessary taxpayer identification numbers;
- retain the copy of the certification; and
- provide the FTB with the certification upon request.

This provision would specify that the credit shall not be allowed to the taxpayer if the taxpayer fails to comply with these requirements.

The credit would be allowed only if the purchaser is the "end user" of the rice straw. The "end user" would be defined as anyone who uses the rice straw for processing, generation of energy, manufacturing, export, prevention of erosion, or for any other purpose, except open burning, which consumes the rice straw. Also, the taxpayer allowed the credit could not be related to the person who grew the rice straw.

This provision would disallow any deduction for the purchase of rice straw used to claim the credit. **This provision** also would disallow the rice straw credit from being claimed if any other credit has been claimed with respect to the purchase of the rice straw.

This provision would provide that if a taxpayer's allowable credit cannot be used in any given year, the excess credit may be carried over for ten years or until exhausted.

The general rules regarding the division of credits would apply and this credit would not reduce regular tax below the tentative minimum tax for AMT purposes.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision would result in a revenue loss of \$400,000 per fiscal year for fiscal years 1997-98 and 1998-99.

18. 50% CREDIT FOR DISABLED COMPLIANCE

EFFECTIVE DATE

This provision would apply to taxable or income years beginning on or after January 1, 1996.

SPECIFIC FINDINGS

Existing federal law allows a credit to eligible small businesses for expenditures paid or incurred after November 5, 1990, to comply with ADA requirements. The federal credit is equal to 50% of the "eligible access expenditures" made in the taxable year exceeding \$250, but not in excess of \$10,250.

"Disability" has the same meaning as used in the ADA which was enacted July 26, 1990. "Eligible small business" is defined as a business:

- with gross receipts (less returns and allowances) that do not exceed \$1 million during the preceding taxable year; or if the gross receipts test exceeds \$1 million, employed no more than 30 full-time employees during the preceding taxable year; and
- that elects to claim the credit.

The credit limitation applies to partnerships and each partner as well as S corporations and each shareholder.

No deduction or credit is allowed for the same expenses and the adjusted basis of any property cannot be increased by the expenses.

"Eligible access expenditures," as defined, include amounts paid or incurred:

- for removing architectural, communication, physical, or transportation barriers preventing access to or use of a business by disabled individuals, except for expenditures paid or incurred for new facilities placed in service after November 5, 1990;
- to provide qualified interpreters or other effective methods of making aurally delivered materials available to hearing impaired individuals;
- to provide qualified readers, taped text or other effective methods of making visually delivered materials to visually impaired individuals;
- to acquire or modify equipment or devices for disabled individuals; or
- to provide other similar services, modifications, materials or equipment.

Expenditures must be reasonable and necessary to provide access to or use by disabled individuals and meet standards promulgated by the Secretary of the Treasury and in compliance with the Architectural and Transportation Barriers Compliance Board.

Existing federal law provides that this credit may not reduce regular tax below the tentative minimum tax.

Existing state and federal laws allow a taxpayer to elect a business expense deduction (instead of depreciation or amortization), not to exceed \$15,000 for removal of architectural and transportation barriers to the handicapped and elderly. "Handicapped" is defined as an individual with a physical or mental disability, including, but not limited to, blindness or deafness which results in a functional limitation to employment or limits one or more of the individual's life activities.

For purposes of the deduction, "architectural and transportation barrier removal expense" means the removal of any facility or vehicle's architectural or transportation barrier where the removal meets promulgated standards.

This provision would allow a state credit in accordance with the existing federal credit, as previously explained. However, the amount of the credit would be equal to 50% of eligible access expenditures that do not exceed \$250.

This provision would not allow a deduction, including the existing deduction for removal of barriers, for the same expenses used to claim this credit.

This provision would not allow the credit to reduce regular tax below tentative minimum tax.

Any allowable credit amount that exceeded the tax liability would be carried over for succeeding taxable or income years, until exhausted.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue loss from this provision of the bill is estimated to be \$300,000 per fiscal year for fiscal years 1996-97, 1997-98 and 1998-99.

19. NON-PROFIT INSURANCE RISK POOLS

EFFECTIVE DATE

This provision would apply to income years beginning on or after January 1, 1996.

SPECIFIC FINDINGS

The Corporations Code governs the formation of corporations in California. A corporation may be incorporated as a "for profit" (stock) corporation or a "nonprofit" (no stock) corporation. "For profit" corporations do not qualify for tax-exempt status. California nonprofit corporations are either public benefit corporations, mutual benefit corporations or religious corporations. Though nonprofit corporations are not automatically tax-exempt, a nonprofit corporation

may apply for tax-exempt status with the FTB. A tax-exempt corporation, which has taxable business income unrelated to its exempt purpose, may incur tax liability under the B&CTL.

Under California law insurance companies doing business in California are generally not subject to the tax on their net income under the B&CTL. Instead, insurers pay a tax based generally on gross premiums received during the year on business done in California. The gross premiums tax rate is set each year by the State Board of Equalization. Since 1990, the tax rate has been set at 2.35%.

Since 1990, the California Corporations Code has specified that an "authorized corporation" involved in a pooling arrangement with two or more other authorized corporations for self-insured claims and losses is not subject to regulation under the Insurance Code when it provides insurance for the following:

- itself against any tort liability;
- any employee of the corporation against liability for injury resulting from an omission in the scope of employment;
- any board member, officer, or volunteer of the corporation against any liability that may arise from any act or omission in the scope of participation with the corporation; and
- any loss arising from physical damage to motor vehicles owned or operated by the corporation;

For an "authorized corporation" to qualify under this Corporations Code provision, the corporation must be exempt from income tax under federal law as a charitable organization under Section 501(c)(3) of the IRC at the time the pooling arrangement is formed.

Under federal law prior to the enactment of the Small Business Job Protection Act of 1996 on August 20, 1996, companies that provide insurance other than life insurance are generally taxed like corporations, with certain deductions peculiar to the insurance industry. Gross income includes investment and underwriting income and gain or loss from property dispositions. Companies whose net written premiums (or direct written premiums, if greater) for the year exceed \$350,000, but do not exceed \$1,200,000, may elect to be taxed only on investment income. In addition, some insurance companies may be exempt from tax.

Insurance companies may qualify for exempt status under Section 501(c)(15) of the IRC, if the net written premiums for the taxable year do not exceed \$350,000. If a company is part of a controlled group, the net written premium test includes all premium amounts received from all members of the controlled group.

Certain insurance companies also may qualify for exempt status under IRC sections 501(c)(3) or (4), if they are organized as mutual benefit corporations and if the insurance company does **not** substantially provide commercial-type insurance. Insurance which does not constitute commercial type insurance includes: any

insurance provided at substantially below cost to a charitable recipient; incidental health insurance provided by an HMO; property or casualty insurance by a church or an association of churches; retirement or welfare benefits by a church or church association for the employees of the church or church association; and charitable gift annuities.

Under the Small Business Job Protection Act of 1996, federal law was changed to provide that a qualified charitable risk pool is treated as organized and operated exclusively for charitable purposes but must satisfy the other requirements for tax exempt status, including the private inurement test and the prohibition of political campaign activities and substantial lobbying. The provision makes inapplicable to a qualified charitable risk pool the rule that a charitable organization is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. It provides that a qualified charitable risk pool is required to (1) be organized as a nonprofit organization under state law authorizing risk pooling for charitable organization; (2) be exempt from state income tax; (3) obtain at least \$1 million in startup capital from nonmember charitable organizations; (4) be controlled by a board of directors elected by its members, and (5) provide in its organizational documents that members must be tax-exempt charitable organizations, and that no insurance coverage applies to a member after the date of any final determination that the member no longer qualifies as a tax-exempt charitable organization.

This provision would apply to organizations formed by three or more exempt charitable organizations joined together for the purpose of self-insurance. It would provide that organizations, which are pooling arrangements authorized under the Corporations Code, may be granted state exempt status under the B&CTL. However, such state exempt status would be conditioned on the member corporations receiving federal tax exempt status under Section 501(c)(3) of the IRC.

Pooling organizations addressed by this provision would be exempt from both the California gross premiums tax and tax under the B&CTL. Such organizations could provide insurance only to members of the pooling arrangement.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's cost of operation.

Tax Revenue Estimate

This provision results in a revenue losses of \$300,000 in fiscal year 1996-97 and \$200,000 per fiscal year for 1997-98 and 1998-99.

20. CREDIT FOR COSTS OF TRANSPORTING CHARITABLE DONATIONS OF AGRICULTURAL PRODUCTS

EFFECTIVE DATE

This provision would apply to taxable or income years beginning on or after January 1, 1996.

SPECIFIC FINDINGS

Under existing state and federal laws, generally all ordinary and necessary expenses of a trade or business are deductible as direct business expense deductions.

Existing state and federal laws allow a taxpayer to claim a deduction for charitable contributions made to a qualified organization.

A charitable contribution is a gift given to or for the use of a qualified organization. It may be in the form of money or property or unreimbursed out-of-pocket expenses incurred by the taxpayer for services rendered to the organization.

The value of a service provided to a qualified organization is not deductible as a charitable contribution. However, out-of-pocket unreimbursed expenses incurred in rendering the service are deductible.

Deductions are allowed for reasonable transportation or other travel expenses (including meals) incurred in performing services away from home for qualified organizations if no significant element of personal pleasure, recreation or vacation is involved. Individuals may determine transportation costs by using \$.12 per mile or the actual transportation expenses. Parking fees and tolls may be deducted as part of the contribution. However, depreciation and insurance are not deductible.

Under the Food and Agriculture Code (F&AC), a person engaged in the business of processing, distributing or selling agricultural products may donate food to a nonprofit charitable organization. Agricultural products include fowl, animal, vegetable, or other stuff, product, or article that is customary or proper food for human beings.

Under the **PITL and the B&CTL**, **this provision** would allow a 50% credit for transportation costs donated for transporting donated agricultural products.

Any deduction that the taxpayer otherwise would be allowed for the eligible costs would be reduced by the amount of the credit.

Upon receipt or delivery of the donated agricultural product, the nonprofit organization would provide to the transporter a certificate signed and dated by an authorized person of the organization. The certificate would state the name and address of the recipient organization, the type and quantity of the product

donated, the distance the product was transported, the name of the transporter and the taxpayer donor, and that the product was donated pursuant to the F&AC. The taxpayer would provide a copy of the certification to the FTB upon request.

If the credit exceeded the taxpayer's tax liability, the excess could be carried over to reduce the tax in the following and succeeding years until the credit is exhausted.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue loss from this provision of the bill is estimated to be \$200,000 per fiscal year for fiscal years 1996-97, 1997-98 and 1998-99.

21. MOVING EXPENSES

EFFECTIVE DATE

Applies to taxable years beginning on or after January 1, 1996.

SPECIFIC FINDINGS

Prior to the 1993 Revenue Reconciliation Act, both federal and state law provided that an employee or self-employed individual may claim a deduction from gross income for certain expenses incurred as a result of moving to a new residence in connection with beginning work at a new location. The deduction was an itemized deduction but not subject to the floor that generally limits a taxpayer's allowable miscellaneous itemized deductions to those amounts that exceed 2% of the taxpayer's adjusted gross income. Any amount received directly or indirectly by such individual as a reimbursement of moving expenses must be included in the taxpayer's gross income as compensation.

Deductible moving expenses were the expenses of transporting the taxpayer and members of the taxpayer's household, as well as household goods and personal effects, from the old residence to the new residence; the cost of meals and lodging enroute; the expenses for pre-move house hunting trips; temporary living expenses for up to 30 days in the general location of the new job; and certain expenses related to either the sale of (or settlement of an unexpired lease) on the old residence, or the purchase of (or acquisition of a lease on) a new residence in the general location of the new job.

The moving expense deduction was subject to a number of limitations. A maximum of \$1,500 could be deducted for pre-move house hunting and temporary living expenses in the general location of the new job. A maximum of \$3,000 (reduced by any deduction claimed for house hunting or temporary living expenses) could be

deducted for certain qualified expenses for the sale or purchase of a residence or settlement or acquisition of a lease. If both a husband and wife begin new jobs in the same general location, the move was treated as a single commencement of work. If a husband and wife file separate returns, the maximum deductible amounts available to each were one-half the amounts otherwise allowed.

Also, in order for a taxpayer to claim a moving expense deduction, the taxpayer's new principal place of work must be at least 35 miles farther from the taxpayer's former residence than was the taxpayer's former principal place of work (or at least 35 miles from the taxpayer's former residence, if the taxpayer has no former place of work).

While these rules remain the current California rules, the 1993 Revenue Reconciliation Act made substantial changes to the rules for federal purposes. That Act excludes from the definition of moving expenses the costs related to: (1) the sale of (or settlement of an unexpired lease on) the old residence, and the purchase of (or acquisition of a lease on) the new residence in the general location of the new job, (2) meals consumed while traveling and while living in temporary quarters near the new job, (3) pre-move house hunting trips, and (4) temporary living expenses for up to 30 days in the general location of the new job. In addition, (1) the mileage limit is increased from 35 miles to 50 miles, (2) moving expenses not paid or reimbursed by the taxpayer's employer are allowable as a deduction in calculating adjusted gross income, and (3) moving expenses paid or reimbursed by the taxpayer's employer are excludable from gross income.

Definition of moving expenses

Moving expenses are defined as the reasonable costs of (1) moving household goods and personal effects from the former residence to the new residence and (2) traveling (including lodging during the period of travel) from the former residence to the new place of residence. Moving expenses do not include any expenses for meals.

Employer-paid moving expenses

Moving expenses are excludable from gross income and wages for income and employment tax purposes to the extent paid by the taxpayer's employer (whether directly or through reimbursement). Moving expenses are not excludable if the taxpayer actually deducted the expenses in a prior taxable year.

Moving expenses not paid for by the employer

Moving expenses are deductible in computing adjusted gross income to the extent not paid by the taxpayer's employer (whether directly or through reimbursement). Allowing such a deduction will treat taxpayers whose expenses are not paid by their employer in a comparable manner to taxpayers whose moving expenses are paid by their employer.

This provision conforms state law to the federal rules for moving expenses.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision results in revenue gains of \$25 million per fiscal year for fiscal year 1996-97, 1997-98 and 1998-99.

22. COMPANY-OWNED LIFE INSURANCE POLICIES

EFFECTIVE DATE

This provision applies to interest paid or accrued after December 31, 1995. This provision will not apply until January 1, 1999, for certain interest paid on loans entered into before 1996 or on loans on certain 1994 or 1995 policies where the loan is made before January 1, 1997. If the policy was issued before June 20, 1986, only the interest rate cap portion of this provision will apply to interest paid or accrued after December 31, 1995.

SPECIFIC FINDINGS

Under both federal and state law, no tax generally is imposed on a policyholder for the earnings under a life insurance contract, commonly called "inside buildup." Further, an exclusion from income is provided for amounts received under a life insurance contract paid on the death of the insured. The policyholder may borrow against the life insurance contract without affecting these exclusions, subject to certain limitations.

These limitations contained in both state and federal law, prior to the enactment of the Health Insurance Portability and Accountability Act of 1996, on August 21, 1996, provided that no deduction was allowed for any interest paid or accrued on indebtedness for one or more company-owned life insurance policies covering the life of any individual who is an officer or employee of, or financially interested in, any trade or business carried on by the taxpayer to the extent that the aggregate amount of that debt with respect to policies covering the individual exceeded \$50,000.

Under the Health Insurance Portability and Accountability Act of 1996, federal law denies a deduction for interest paid or accrued on any indebtedness for one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is an officer or employee of, or financially interested in, any trade or business carried on by the taxpayer. An exception retains the prior law deduction for up to 20 key persons. Interest paid or accrued after December 31, 1995, on debt with respect to a life insurance contract covering a key person is capped by reference to Moody's Corporate Bond

Yield Average-Monthly Average Corporates for each month interest is paid or accrued. A phase-in of this Moody's rate is provided.

This provision would conform state law to the new federal law.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision will result in revenue gains of \$10 million for fiscal year 1996-97, \$15 million for fiscal year 1997-98 and \$20 million for fiscal year 1998-99.

23. CORPORATION ESTIMATED TAX

EFFECTIVE DATE

This provision continues the current state law 95% requirement for income years beginning on or after January 1, 1996, and before January 1, 1998; increases the percentage to 98% for income years beginning on or after January 1, 1998, and before January 1, 1999; and 100% for income years beginning on or after January 1, 1999, and thereafter. The annualization election changes would apply to income years beginning on or after January 1, 1997.

SPECIFIC FINDINGS

Under existing federal law the corporate estimated tax rules provide that estimated tax payments must be based on 100% of the tax shown on a corporation's return for the current year. Also, corporations may elect to annualize income over one of three specific of periods of time.

Current state law requires that a corporation's estimated tax be based on 95% of the tax shown on the return and is conformed to the prior federal law which only provided two periods over which the corporation was allowed to annualize income.

This provision would phase-in conformity to require 100% of the tax for the current year to be paid in four installments by corporations in order to avoid a penalty. In addition, this provision also would conform to the changes made in the annualization election.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision would result in no revenue impact in the 1996-97 fiscal year; and revenue gains of \$11 million in the 1997-98 fiscal year, and \$13 million in the 1998-99 fiscal year.

24. MARK-TO-MARKET ACCOUNTING

EFFECTIVE DATE

This provision would apply to taxable or income years beginning on or after January 1, 1997.

SPECIFIC FINDINGS

Federal law, as amended by the Revenue Reconciliation Act of 1993, provides two general rules (the "mark-to-market rules") that apply to certain securities that are held by a dealer. First, any such security that is inventory in the hands of the dealer is required to be included in inventory at its fair market value. Second, any such security that is not inventory in the hands of the dealer and that is held as of the close of any taxable year is treated as sold by the dealer for its fair market value on the last business day of the taxable year. Any unrealized gain or loss must be taken into account by the dealer in determining gross income for that taxable year.

If gain or loss is taken into account with respect to a security by reason of the second mark-to-market rule, then the amount of any gain or loss subsequently realized as a result of the sale, exchange, or other disposition of the security, or as a result of the subsequent application of the mark-to-market rules in a succeeding taxable year, is to be appropriately adjusted to reflect such gain or loss.

Any gain or loss taken into account under the mark-to-market provisions (or any gain or loss recognized with respect to a security that would be subject to the mark-to-market provisions if held at the end of the year) generally is treated as ordinary gain or loss. This characterization rule does not apply to any gain or loss allocable to any period during which the security (1) is a hedge of a position, right to income, or a liability that is not subject to the mark-to-market rules, or (2) is held by the taxpayer other than in its capacity as a dealer in securities. In addition, this characterization rule does not apply to any security that is improperly identified by the taxpayer.

Federal law provides explicit definitions for both "dealer" and "securities."

The exceptions to the mark-to-market rules do not apply unless, before the close of the day on which the security (including any evidence of indebtedness) is acquired, originated, or entered into (or such other time as the Treasury Department may specify in regulations), the security is clearly identified in the dealer's records as being described in one of the exceptions listed above.

Federal law generally provides that any gain or loss with respect to hedges that are subject to the mark-to-market rules will be treated as ordinary gain or loss.

The **federal law**, in general, applies to taxable years ending on or after December 31, 1993.

A taxpayer that is required to change its method of accounting to comply with the requirements of this law is treated as having initiated the change in method of accounting and as having received the consent of the Treasury Department to make such change. The net amount of the adjustment is to be taken into account ratably over a five-taxable year period beginning with the first taxable year ending on or after December 31, 1993.

State law is conformed to prior federal law and requires a dealer in securities to maintain an inventory of those securities held for sale to customers. For tax purposes, the dealer is allowed to determine (or value) the inventory of securities held for sale based on: (1) the cost of the securities; (2) the lower of the cost or market (LCM) value of the securities; or (3) the fair market value of the securities.

If the inventory of securities is determined based on historical cost, unrealized gains and losses with respect to the securities are not taken into account for income tax purposes. If the inventory of securities is determined based on the LCM value, unrealized losses (but not unrealized gains) with respect to the securities are taken into account for income tax purposes in each annual accounting period. If the inventory of securities is determined based on market value, both unrealized gains and losses with respect to the securities are taken into account for income tax purposes.

The department is currently drafting a legal ruling that recognizes that since mark-to-market accounting was one of the permissible methods under the prior federal law (to which California conformed), taxpayers may request permission from the department to change to this method for state purposes.

Under the PITL and the B&CTL, this provision would conform state law to the federal laws regarding mark-to-market accounting methods for securities dealers.

This provision also would provide that the net amount of the required adjustment must be taken into account ratably over a five-taxable or income year period beginning with the first taxable or income year beginning on or after January 1, 1998.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision would result in no revenue impact in the 1996-97 fiscal year, and revenue gains of \$10 million per fiscal year for 1997-98 and 1998-99.

25. RESTRICTION OF DEDUCTION OF INTEREST TO FOREIGN ENTITIES

EFFECTIVE DATE

This provision would apply to income years beginning on or after January 1, 1996.

SPECIFIC FINDINGS

Under current federal law, interest is subject to disallowance under the "earnings stripping" rules without regard to whether it is interest on a fixed-term obligation issued before, on, or after July 10, 1989. Interest paid on a loan from an unrelated party generally is treated under the "earnings stripping" rules as interest paid to a related person with respect to which no U.S. tax is imposed if:

- 1) no gross-basis U.S. income tax is imposed on the interest (regardless if the interest recipient is subject to net-basis U.S. income tax with respect to that interest);
- 2) a related person guaranteed the loan; and
- 3) the related person is either exempt from U.S. federal income tax or is a foreign person.

Exceptions apply where the taxpayer controls the guarantor and in cases, identified by regulation, where the interest on the indebtedness would have been subject to net-basis tax if the interest had been paid to the guarantor. Except as provided in regulations, a guarantee is defined to include any arrangement under which a person directly or indirectly assures, on a conditional or unconditional basis, the payment of another's obligation.

Under current California law interest expenses of a California corporate taxpayer are generally deductible, regardless of whether the interest is paid to a related party or whether the interest income is subject to California taxation in the hands of the recipient. In certain cases where interest is paid by a corporation to a related person, and no California tax is imposed on the recipient's interest income, California conforms to the so-called "earnings stripping rules" in federal law which provide for denial of interest deductions by the corporate payor to the extent that the corporation's net interest expenses exceed 50% of its adjusted taxable income.

For those corporations which compute their tax under the formulary apportionment rules, deductible interest is, in general, limited to interest income subject to formula apportionment, plus the excess of the balance of interest expense over the amount of interest and dividend income not subject to formula apportionment.

This provision would conform to the federal rules related to guarantors described above for income years beginning on or after January 1, 1996.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision would result in revenue gains of \$3 million per fiscal year for fiscal years 1996-97 and 1997-98, and \$4 million for fiscal year 1998-99.

26. PAYMENT TO RETIRED OR DECEASED PARTNERS

EFFECTIVE DATE

This provision would apply to taxable or income years beginning on or after January 1, 1996, for payments to partners who died or retired after January 4, 1993.

SPECIFIC FINDINGS

Under current federal law payments made to partners retiring or dying on or after January 5, 1993, are treated as a distributed share of partnership income or as a guaranteed payment if:

- capital is not a material income-producing factor for the partnership; and
- the retiring or deceased partner was a general partner in the partnership.

If these two requirements are not satisfied, payments for unrealized receivables and goodwill are treated as made in exchange for property and do not give rise to a deduction or its equivalent for the partnership.

Current state law provides that all amounts paid in liquidation of a retiring or deceased partner's interest with respect to unrealized receivables and goodwill receive special consideration. That is, such payments are treated as a payment and, therefore, give rise to a deduction or its equivalent for the partnership.

This provision would conform to federal law applicable to treatment of certain payments to retired or deceased partners made in taxable years beginning on or after January 1, 1996, for payments to partners who died or retired after January 4, 1993.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision would result in revenue gains of \$2 million per fiscal year for fiscal years 1996-97 and 1997-98 and \$3 million for fiscal year 1998-99.

27. DISCLOSURE OF EDD'S NEW EMPLOYEE REGISTRY INFORMATION

EFFECTIVE DATE

This provision would be effective on January 1, 1997.

SPECIFIC FINDINGS

Current California law requires employers, in general, to report the employee's name and social security number to EDD within 30 days of the hiring, rehiring or returning to work of an employee. EDD is authorized to use this information only for purposes of child support enforcement and benefit overpayments.

This provision would modify existing law to allow the EDD to provide new-employee registry information to FTB, upon request, for tax enforcement purposes.

FISCAL IMPACT

Departmental Costs

This provision should not significantly increase the department's costs.

Tax Revenue Estimate

This provision would accelerate the receipt of General Fund revenues under the PITL to the extent it provides for more timely collection of delinquent tax liabilities. In addition, there is a potential for additional collection of delinquent taxes representing new revenue to the state of \$1 million per fiscal year for fiscal years 1997-98 and 1998-99.

28. SPOUSAL TRAVEL

EFFECTIVE DATE

This provision would be effective for amounts paid or incurred on or after January 1, 1996, in taxable and income years beginning on or after January 1, 1996.

SPECIFIC FINDINGS

Under both federal and state laws, a taxpayer is permitted a deduction for all ordinary and necessary expenses paid or incurred during the taxable year (1) in carrying on any trade or business and (2) in the case of an individual, for the production of income. The deductible expenses may include reasonable travel expenses paid or incurred while away from home, such as transportation costs and a percentage of the cost of meals and lodging.

Prior to the 1993 Revenue Reconciliation Act, Treasury regulations provided that if a spouse accompanied the taxpayer on a business trip, expenses attributable to the spouse's travel are not deductible unless it is adequately shown that the spouse's presence on the trip has a bona fide business purpose and some incidental service by the spouse did not cause those expenses to qualify as deductible business expenses. Under these Treasury regulations, the same rules apply to any other members of the taxpayer's family who accompany the taxpayer on the trip.

The 1993 Revenue Reconciliation Act denies a deduction for travel expenses paid or incurred with respect to a spouse, dependent, or other individual accompanying a person on business travel, unless (1) the spouse, dependent, or other individual accompanying the person is a bona fide employee of the person paying or reimbursing the expenses, (2) the travel of the spouse, dependent, or other individual is for a bona fide business purpose, and (3) the expenses of the spouse, dependent, or other individual would otherwise be deductible. The denial of the deduction does not apply to expenses that would otherwise qualify as deductible moving expenses.

This provision would conform state law to federal treatment of travel expenses incurred for a spouse, dependent, or other individual accompanying a person on business travel.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision would result in revenue gains of \$1 million per fiscal year for fiscal years 1996-97, 1997-98 and 1998-99.

29. DEPRECIATION OF REAL PROPERTY

EFFECTIVE DATE

This provision would apply to property placed in service on or after January 1, 1997, in taxable or income years beginning on or after January 1, 1997.

SPECIFIC FINDINGS

Existing federal law allows a depreciation recovery period for nonresidential rental property of 39 years. This provision generally applies with respect to property placed in service on or after May 13, 1993.

Current PITL uses a recovery period for depreciating nonresidential real property of 31.5 years. This means that taxpayers have a shorter depreciation period, which results in a higher depreciation amount than under current federal law.

Current B&CTL utilizes the asset depreciation range system of depreciation under which nonresidential rental property must be recovered over a period of 40 to 60 years.

This provision would conform the PITL to federal law applicable to nonresidential rental property placed in service on or after January 1, 1997, in taxable years beginning on or after January 1, 1997. No change is made to the depreciation of nonresidential rental property under the B&CTL.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

This provision would result in no revenue impact in the 1996-97 fiscal year, and revenue gains of \$1 million per fiscal year for the 1997-98 and 1998-99 fiscal year.

30. EXPANSION OF CALIFORNIA'S NEXUS PROGRAM

EFFECTIVE DATE

This provision would apply to taxable or income years beginning on or after January 1, 1997.

SPECIFIC FINDINGS

Under California's Nexus Program, in general, an out-of-state corporation or bank that has minimal California presence/activities (e.g., does not maintain a sales, service or administrative office or has not qualified to do business in California) can, through a voluntary disclosure agreement, come forward to voluntarily disclose California franchise/income tax liabilities and/or unfiled tax returns for the last six years and continue to file required tax returns and pay the taxes due. FTB is authorized to waive penalties with respect to the tax returns that are filed for the six-year period and waive its authority to assess or propose to assess taxes, additions to tax, fees or penalties with respect to years ending six years before the signing of that agreement, subject to

approval/disapproval by the FTB members. The statute provides that the identity of the taxpayer is not disclosed until the agreement is approved and signed.

This provision would expand California's existing Nexus Program to include qualified Subchapter S corporation shareholders. This provision would define "qualified shareholder" as an individual that is all of the following:

- A nonresident on the signing date of the voluntary disclosure agreement.
- A shareholder of an S corporation (as defined in R&TC Section 23800) that has applied for a voluntary disclosure agreement under this article under which all material facts pertinent to the shareholder's liability would be disclosed on that S corporation's voluntary disclosure agreement.

Additionally, this provision would define "signing date" of the voluntary disclosure agreement as the date on which a person duly authorized by the FTB signs the agreement. This provision would apply only to California source income attributable to the S Corporation.

FISCAL IMPACT

Departmental Costs

No significant departmental costs are anticipated with this provision.

Tax Revenue Estimate

This provision would result in no revenue impact in the 1996-97 fiscal year, and revenue gains of \$2.5 million per fiscal year for the 1997-98 and 1998-99 fiscal year.